Supreme Court, U. S.
FILED
SEP 14 1979
MICHAEL RODAK, JR., CLERK

No. 79-98

In the Supreme Court of the United States

OCTOBER TERM, 1978

JACK'S COOKIE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530

In the Supreme Court of the United States

OCTOBER TERM, 1978

No. 79-98

JACK'S COOKIE COMPANY, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FOURTH CIRCUIT

MEMORANDUM FOR THE UNITED STATES IN OPPOSITION

The question presented in this federal income tax case is whether petitioner's payment of $20,479.08 into a bond reserve fund in 1970 pursuant to the terms of a lease was a currently deductible rental expense under Section 162(a)(3) of the Internal Revenue Code of 1954 (26 U.S.C.), or, as the court of appeals held, a nondeductible capital outlay.

The pertinent facts are undisputed and may be summarized as follows: Petitioner is an Ohio corporation engaged in producing and selling cookies and other baked goods. In 1962, it entered into an agreement with the government of Giles County, Tennessee, to rent an industrial building to be constructed and equipped by the county. To finance this project, the County Court of Giles

County authorized two issues of interest-bearing industrial development bonds, each in the principal amount of $1,250,000, and each to mature serially over a 30-year period (Pet. App. 3a). See Tenn. Code Ann. §§ 6-1701 *et seq.*, 6-2901 *et seq.* (1971).

Under an agreement dated June 1, 1962, petitioner agreed to lease the building from Giles County for a primary term of 30 years at "monthly rentals" designed to equal the interest, principal payments, and administration expenses required on the industrial development bond issues. Petitioner also agreed to pay additional monthly rentals, which were described as "reserve payments" by the lease. The lease required the reserve payments to be paid in equal monthly installments over the first 15 years of the lease until the aggregate sum of $285,000 was accumulated in a bond reserve fund (Pet. App. 3a-4a, 30a-31a).

The indenture of mortgage executed by petitioner, the county and the trustee for the bondholders, expressly provided that the trustee had to accumulate the reserve payments in the bond reserve fund solely as security for the future payment of the bonds. In the event of default by petitioner, the bond reserve fund would be applied toward the payment of outstanding bond obligations. The indenture also provided that the trustee, at the direction of petitioner, would invest all surplus amounts in the bond reserve fund in direct obligations of the United States having a maximum maturity date of ten years. The interest earned on such investments was to be deposited in the bond reserve fund (Pet. App. 4a-5a; R. 51).[1]

[1]"R." refers to the record appendix filed in the court of appeals.

The lease agreement further provided petitioner with certain options to apply the bond reserve fund against its future rent liability. If, at any time after the fifteenth year from the issuance of the bonds, petitioner elected to prepay its remaining rentals due under the lease, it would receive a credit against its prepayment liability for the amounts then in the bond reserve fund (Pet. App. 5a, 31a). Petitioner could receive an identical credit if, in the case of damage to or condemnation of the premises, it chose to exercise its option to pay all remaining rentals and terminate the lease (Pet. App. 5a, 31a-36a).

On its income tax return for its taxable year ending October 2, 1970, petitioner included in its claimed rental expense deduction the amount of $20,479.08 for reserve payments it made to Giles County during that year pursuant to the lease agreement. On audit, the Commissioner of Internal Revenue disallowed the deduction on the ground that the payments made represented nondeductible capital expenditures.[2] In a refund suit brought by petitioner in the United States District Court for the Western District of North Carolina, the district court upheld petitioner's claimed rental deduction (Pet. App. 1a). The court of appeals reversed (Pet. App. 2a-24a). In the court of appeals' view, "the fund into which the reserve element of the rents was paid was essentially a 'separate and distinct asset' which must be capitalized" (Pet. App. 23a).

1. Petitioner argues (Pet. 5) that in holding its bond reserve fund payments to be nondeductible capital outlays, the court of appeals misapplied this Court's

[2]The Commissioner did allow petitioner a rental expense deduction for the remaining portion of the $191,720.92 it paid to Giles County during its taxable year 1970 (R. 14).

decision in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, 403 U.S. 345 (1971). While Section 162(a) of the Code allows a current deduction for ordinary and necessary business expenses, including rental paid for business property, expenditures that are capital in nature are not currently deductible. See Section 263. Thus, where an expenditure, although required by business exigencies, results in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year, it must be capitalized. *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*; *United States* v. *Mississippi Chemical Corp.*, 405 U.S. 298 (1972); *Richmond Television Corp.* v. *United States*, 345 F. 2d 901 (4th Cir.), vacated and remanded on another issue, 382 U.S. 68 (1965). On the basis of this settled principle, the court of appeals correctly held that petitioner's payments into the bond reserve fund during 1970 were nondeductible capital expenditures (Pet. App. 2a-24a).

Here, the reserve payments at issue were not required by Giles County to satisfy any actual bond obligations during the taxable year in question. Instead, those payments were paid into the reserve fund as security for the future payment of the bonds in the event of default by petitioner. Moreover, under the lease petitioner retained substantial rights to have the bond reserve fund, and any investment income generated by the fund, applied for its benefit in subsequent taxable years. Thus, petitioner could elect to prepay its remaining rentals due under the lease, and if it did so, it would receive a credit against its prepayment liability for the balance then in the reserve fund.[3] Petitioner could receive a similar credit if, in case

[3]Petitioner conceded at oral argument in the court of appeals that would be " 'economically foolish' " not to prepay its rent at some time in order to get the full benefit of the amounts in the bond reserve fund as a credit against its future rent (Pet. App. 5a n. 6).

of damage to or condemnation of the premises, it exercised its option to pay all remaining rentals and terminate the lease. Under these circumstances, the reserve payments do not constitute deductible expenses, since, despite their characterization under the lease as "rentals," the payments were not made for petitioner's current use and occupancy of the premises. Moreover, there was a substantial possibility that the amounts would be applied for petitioner's benefit in the future. *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*. See also *Kohler-Campbell Corp.* v. *United States*, 298 F. 2d 911 (4th Cir. 1962); *Galatoire Bros.* v. *Lines*, 23 F. 2d 676 (5th Cir. 1928); *Minneapolis Security Building Corp.* v. *Commissioner*, 38 B.T.A. 1220 (1938).

There is accordingly no basis for petitioner's contention that the decision below is contrary to *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*. Indeed, as the court of appeals recognized (Pet. App. 24a), "there is little of significance to distinguish the two cases." In *Lincoln Savings & Loan Ass'n*, this Court held that certain insurance premium prepayments made by a savings and loan association into a reserve fund did not constitute deductible expenses in the year paid because the payments served to create or enhance "a separate and distinct additional asset * * *." 403 U.S. at 354. Here, as in *Lincoln Savings & Loan Ass'n*, petitioner has "a distinct and recognized property interest in the * * * [r]eserve" in an amount equal to the sum of the reserve payments plus any investment income earned thereon (Pet. App. 23a; R.

[4]Contrary to petitioner's further argument (Pet. 6-7), the fact that petitioner could not easily convert its interest in the bond reserve fund into cash or other liquid assets does not require a different result. The restrictions on petitioner's ability to control the reserve fund do not alter the fundamental capital character of that fund. *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*, 403 U.S. at 357.

85).[4] 403 U.S. at 355. The decision of the court of appeals is therefore entirely consistent with *Lincoln Savings & Loan Ass'n.*

2. Petitioner renews its arguement (Pet. 6-7), rejected by this Court in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*, 403 U.S. at 358, that because its reserve fund payments represent a cash outlay which reduces its net income on its books for financial accounting purposes, the annual system of accounting for tax purposes requires that the payments be deducted in the year they are paid. That fact, however, is irrelevant. The expenditures here resulted in the creation of an asset having a useful life extending beyond the close of the taxable year and may not be deducted merely because the liability to make the payment became fixed during the taxable year. To the contrary, proper tax accounting requires that a deduction be allowed for the reserve fund payments as they are finally applied in future years to discharge petitioner's obligations under the lease.[5] Only in this manner will the income earned in a particular year be matched with the expense attributable to the production of that income. *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*; *United States* v. *Anderson*, 269 U.S. 422, 440 (1926); *Sandor* v. *Commissioner*, 536 F. 2d 874 (9th Cir. 1976); *Commissioner* v. *Boylston Market Ass'n*, 131 F. 2d 966 (1st Cir. 1942). See Treasury Regulations on Income Tax Section 1.461-1(a)(1) (26 C.F.R.).

---

[5]Petitioner asserts (Pet. 7-8) that the decision below "conflicts in principle" with *Benton* v. *Commissioner*, 197 F. 2d 745 (5th Cir. 1952), and *WBSR, Inc.* v. *Commissioner*, 30 T.C. 747 (1958). But those cases involved the wholly different question whether an option to purchase at the expiration of a lease may characterize the lease as a contract of sale for tax purposes; the deductibility of a reserve payment was not in issue in either case.

3. Finally, petitioner argues (Pet. 7-8) that the reserve payments are deductible because it had a fixed liability under both the lease agreement and state law to make such payments as a condition to its continued use and possession of the premises. But as this Court made clear in *Commissioner* v. *Lincoln Savings & Loan Ass'n*, *supra*, 403 U.S. at 358-359, the fact that a payment is compulsorily imposed upon a taxpayer does not render it deductible (Pet. App. 6a-13a, 24a). See also *Duffy* v. *Central R.R.*, 268 U.S. 55 (1925); *Woolrich Woolen Mills* v. *United States*, 289 F. 2d 444 (3d Cir. 1961); *Teitelbaum* v. *Commissioner*, 294 F. 2d 541 (7th Cir. 1961).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

SEPTEMBER 1979

DOJ-1979-09